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Understanding How an ARM Loan Interest Rate Works

As concern continues to grow over consumer awareness about adjustable rate mortgage (ARM) loans, especially among sub-prime borrowers, U.S. regulators and many mortgage lenders have been trying to educate people better about the risks of these loans. The increased use of ARMs, including exotic varieties like the interest-only and pay option ARM, have led to higher foreclosure rates among poor-credit homebuyers. While part of the problem may be that ARMs helped people get into homes that were really more than they could afford, a big part of the higher foreclosure rates is the 'payment shock' that awaits many of these borrowers when their interest rate resets. If you are considering buying a home with the help of an ARM loan, you should do your part to educate yourself about the way these programs work. Here is some information gleaned from the ARM pamphlet put out by the Federal Reserve Board and the Office of Thrift Supervision.

An Adjusting Rate

Unlike a fixed rate mortgage, the interest rate on an ARM loan will change periodically. The amount of time between rate adjustments is called the adjustment period. The most common ARM loans adjust either every year, every three years or every five years. There are other variations that adjust at shorter or longer periods and you should speak with a mortgage professional to decide which type is best for you. No matter when your rate adjusts, you should be prepared for the change.

Rates are Tied To Indexes

How do lenders determine if your rate will go up or down? They base your rate on the movement of a specific market index. There are a dozen or so different indexes that your lender might choose to link to your loan, but they must let you know which one and you can then track its movement. Some of the most popular ARM indexes are the one-year, three-year, and five-year Treasury securities. Another common option is the Cost of Funds index.

Once you find out the index your loan is tied to, you can look at the history of its movement to get a rough idea of how it changes and how often. The basic idea though, is that when the index goes up, so does your interest rate and vice versa.

Margins

Determining the exact interest rate is a little more complicated than just following the specific index. Lenders alls use something called "the margin." This is a certain amount of extra percentage points that the mortgage lender adds on top of the index rate. While it is determined by the lender, at least it will be a constant amount for the life of the loan. You should ask the lender what percent he or she charges as the margin when you are shopping around for a loan. It could mean the difference of a hundred dollars or more on every monthly mortgage payment.

Hopefully, you now have a slightly more educated understanding of how your ARM rate is calculated. Be sure to talk with a trusted mortgage professional to learn about the risks associated with these loans. You should also try to determine before hand what the maximum

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monthly payment would be that you might have to make. If you can afford to make the maximum, the loan is probably a good fit for you. If you cannot, you should try looking for a different mortgage program.

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